No. 92-1384

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1992

BARCLAYS BANK PLC
Petitioner,
VS.
FRANCHISE TAX BOARD,
An Agency of the State of California
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEAL OF THE STATE OF CALIFORNIA IN AND FOR THE THIRD APPELLATE DISTRICT

BRIEF OF THE CONFEDERATION OF BRITISH INDUSTRY AS AMICUS CURIAE IN SUPPORT OF THE PETITION FOR CERTIORARI

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Pursuant to Rule 37 of the Rules of this Court, this brief is respectfully submitted in support of the Petition for a Writ of Certiorari by amicus curiae the Confederation of British Industry. The parties have consented to the filing of this brief, and their written consents have been filed with the Clerk of this Court.

INTEREST OF AMICUS CURIAE

The Confederation of British Industry ("CBI") is an independent, non-party, non-political body organized in the United Kingdom. Its members include industrial, commercial, and public sector companies; employer organization and trade associations that represent individual manufacturing industries; and commercial associations. The CBI represents more than 250,000 busi-

nesses which together employ about half of the British workforce. The CBI is the effective voice of business in Britain.

A number of the CBI's members do business in the United States or own subsidiary companies that do business in the United States. The CBI, on behalf of its members, has a substantial and direct interest in taxation of United Kingdom companies. California's use of worldwide combined reporting has a direct and adverse impact on those members of the CBI that operate in the United States and on their U.S. affiliates.

The CBI values highly the maintenance of free world trade and positive economic links between the United Kingdom and the United States. The CBI believes worldwide combined reporting to be fundamentally destructive of foreign investment in the United States and therefore of broader trade relationships between the United States and other countries. The CBI actively opposes the use of worldwide combined reporting and has sought to eliminate worldwide combined reporting's discriminatory taxation system as applied to U.K. corporate groups.

INTRODUCTION AND SUMMARY OF ARGUMENT

California's system for apportioning the income of a multinational business, worldwide combined reporting, is inconsistent and incompatible with the system found by this Court to be the accepted international standard, arm's length separate accounting. *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 184 (1983). The purpose of this accepted standard is to mitigate or eliminate the many problems which can arise when nations claim jurisdiction over the profits of international business for taxation. Without such a standard nations cannot properly protect their domiciliary enterprises or their own fiscs when such enterprises trade abroad. Double taxation, uncertainty of treatment and undue compliance costs may make such international businesses less competitive and hence less profitable. The United States as the largest international trader is the most exposed.

California's use of an incompatible system justifiably enrages other nations. Perpetuation of that system will remove all incentive for such nations to continue to use the accepted and consistent international standard in dealings with the United States. Conflict among nations undoubtedly will occur as countries adopt systems modified to suit themselves or retaliate against United States business.

The California Supreme Court, in upholding California's use of its aberrant system, ignored this Court's historic concern for and sensitivity to international conflicts such as these. The California Court of Appeal recognized that the added compliance burden imposed by worldwide combined reporting justified foreign protest — but still did not overturn the California method. This Court must not allow California to destroy decades of consistent United States effort. This Court must review this case.

ARGUMENT

The major trading nations of the world have adopted the arm's length method as the international standard to divide income among nations for tax purposes. This Court has found this method to be the internationally accepted method. *Container*, 463 U.S. at 184.

Under separate accounting, each legal entity is a separate taxpayer to whom taxing jurisdiction applies separately. A nation taxes a foreign entity only when the entity does business in the nation directly rather than through a subsidiary, and then taxes only the profits arising in that nation. Jurisdiction of a country to tax any particular legal entity does not imply jurisdiction to tax related entities. The aim of the arm's length approach is to ensure that profits of multinational enterprises are allocated in such a manner that each country is able to tax the profits (but no more and no less) actually earned in the country.

Separate entity treatment is not absolute. Nations customarily reserve the right to examine transactions between related entities (or branches) to determine whether the transactions were at "arm's length" (that is, comparable to transactions between unrelated entities). The theory is that income realized on transactions governed by the marketplace is true economic income. Where a transaction was not carried out on an "arm's length"

basis, tax administrators may reallocate income or deductions between the entities to reflect marketplace amounts. The fundamental purpose and reach of the arm's length standard, however, is to fairly determine the marketplace profits ascribable to the trade or business carried out by the foreign entity (or subsidiary) within the taxing jurisdiction.[1]

California's worldwide combined reporting, on the other hand, requires aggregation of the income and deductions of each entity which is a member of a "unitary group", whether or not the other members carry on operations directly in the taxing jurisdiction. Its reach is worldwide and encompasses entities and activities with no real connection to California. California determines its "proper" share of the aggregate income by formula. In making this allegedly "proper" division, formulary apportionment rejects the experience of the marketplace. Implicit in the unitary system is the unwarranted assumption that profit rates in different units of a corporate family, engaged in different activities and in different locations, are always the same.

As a marketplace-based system, the arm's length method takes into account differing economic conditions in different source nations that can create different rates of return on investments. Rates of return clearly do differ. For example, in developing countries, property and payroll costs may be very low relative to those in the United States, with correspondingly higher profits. Companies investing in these countries will often demand higher profits to reflect the risks of expropriation, currency exchange limitations, or other factors. Even among developed nations, differences in market conditions result from different economic conditions, different standards of living, different payroll and property costs, and different tax rates; as well as from other costs imposed on companies by governments including environmental regulation, currency exchange regulations, worker safety, welfare, administrative compliance, and a host of other variables.

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[1]The Internal Revenue Service's authority for this reallocation is found in Section 482 of the Internal Revenue Code (26 U.S.C. § 482). The United Kingdom grants the Inland Revenue similar power.

Double taxation is the one easily perceived result of incompatible systems.[2] Over many years the major trading nations, led by the United States, have adopted a single standard to eliminate or at least to mitigate double taxation between nations. The international network of bilateral income tax treaties — not just between the United States and its treaty partners but also between other nations[3] — defines the jurisdiction of nations to tax resident companies of other nations. The standard also is embodied in the internal laws of nations and in model treaties. Thus, the standard provides a framework for resolution of disputes and fosters cooperation rather than conflict.

However, treaties and other tax harmonization techniques are capable of resolving conflicts only when the two jurisdictions have generally similar rules for dividing income. When a jurisdiction uses worldwide combined reporting, it has no common ground for working out differences with separate accounting jurisdictions. Elimination of double taxation, at a minimum, would require complex adjustment to the apportionment factors to take into account the varying profitability in each jurisdiction. Such adjustments necessarily would differ from jurisdiction to jurisdiction and from industry to industry. Harmonization is not practically possible.

Business and trade suffer when enterprises are forced to comply with inconsistent systems. One advantage of the international

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[2]Because the two systems will assign different amounts of income to jurisdictions in which rates of return differ, double taxation undoubtedly will occur. The problem of double taxation is especially severe where the entity operating in the worldwide combined reporting jurisdiction incurs a loss. The arm's length method would permit the entity to report this loss for tax purposes. Under worldwide combined reporting, if the entity were part of an overall group which realized an aggregate profit, the worldwide combined reporting jurisdiction would allocate to itself some of that overall profit. Because the separate accounting jurisdictions in which the profits arose would also source to themselves 100 percent of the profits, the multinational enterprise would pay a double tax.

[3]In 1986, the United Kingdom had over 70 treaties, each using the arms' length standard.

standard is that it does not force a foreign enterprise to reconstruct its *worldwide* information gathering systems (and those of its affiliates) in order to comply with tax reporting requirements in the nations in which it does business. California's system forces a business to do exactly that, requiring recomputation of worldwide income in accordance with U.S. accounting principles rather than those applicable locally, conversion into U.S. dollars, and translation of records into English. The California Court of Appeal recognized that foreign businesses do not have information systems needed to comply and would not *create* such system but for the California method. Petitioner's Appendix D at D-9, Appendix B at B-25 to B-26.

Further, the purpose of an international standard is not only to eliminate disputes among nations as to how and what they will tax, but also to provide a framework of certainty to businesses making foreign investments. Because there are no precise guidelines for determining when California will deem related entities to constitute a unitary enterprise, an enterprise considering an investment in California cannot know whether it will be subject to worldwide combined reporting. Assuming that the enterprise is deemed unitary, its California tax liability will depend not solely upon its activities in California (or even in the United States), but also upon its rates of return in any other nations in which the "unitary" enterprise has operations. Such variables are incapable of accurate estimation, and severe distortions inevitably will result.

These compliance burdens and uncertainties make the enterprise substantially less likely to make the proposed investment.[4]

[4]This Court has held that a state tax violated the interstate commerce clause when it "foreclose[d] tax-neutral decisions." *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 331 (1977). Worldwide combined reporting does just that.

California's excursion into international tax has had predictable results. Nations have protested vociferously and have threatened retaliation. This Court anticipated this result in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 450-51 (1979):

> If the State imposes an apportioned tax, international disputes over reconciling apportionment formulae may arise. If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions.

More recently, in *Kraft General Foods, Inc. v. Iowa Dep't of Revenue and Fin.*, 112 S.Ct. 2365, 2370 (1992), this Court reaffirmed that the protection granted foreign commerce was broader than that granted to interstate commerce, "in part because matters of concern to the entire Nation are implicated."

As this Court noted in both *Japan Line* and *Container*, there is no ultimate international arbiter who can reconcile disputes among nations over tax systems. 441 U.S. at 447; 463 U.S. at 192. The nations themselves, led by the United States, have adopted the international arm's length standard to avoid exactly this problem. They have substituted cooperation for conflict. California is not a nation; it cannot participate in the dialogue of nations. If allowed to stand, California's aberrant system will continue to act as an irritant until other nations retaliate, not just against California, but against the United States as a whole. Further, California's system runs counter to established United States foreign tax policy and threatens, by its extraterritorial reach, the comity of nations.

CONCLUSION

The California Supreme Court and the Court of Appeal on remand did not even make a pretense of taking into account the important national policies which the international standard represents. It requires an affirmative act of Congress, not the negative inference by inaction perceived by the California Court, to unravel over sixty years of international effort. That is the potential effect of the California Court's decision. This Court should grant the Petition For a Writ of Certiorari.

Respectfully submitted,

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